SHARE PURCHASE WARRANTY CLAIMS

SEMINAR FOR PARKLANE PLOWDEN CHAMBERS
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1. This seminar deals with claims arising out of agreements for the sale of the entire issued share capital of a company ("the Company") by its members ("V") to unconnected purchasers ("P"). Agreements for the sale of part of the issued share capital of a company (whether under an unfair prejudice petition or otherwise) do not usually involve the same sales procedure.

2. The usual principle of caveat emptor applies to such an agreement ("SPA") and the drafting of the same involves usually involves an attempt by P to require V to take all of the risks associated with the sale by way of express and usually lengthy warranties and an attempt by V to remove some of those risks by way of written disclosure. However, not all SPAs include such warranties. They are not usually given:
    1) where P already know all that can be known about the Company such as when they are its management team; or
    2) where V do not know sufficient facts about the Company to give warranties such as when they are trustees, personal representatives or insolvency practitioners.

3. There is no standard form for a SPA, but most have the following features:
    1) Definitions of the key concepts
    2) The basic obligations to buy and sell including the method of computation of the purchase price.
    3) Completion obligations including the precise steps needed to enable P to take

over the smooth running of the Company

4) Express lengthy warranties as to the assets of the Company and its trading position as modified or restricted by a single disclosure letter (with annexed documents). Warranties take effect at exchange but will normally be stated to continue until completion.

5) Mechanisms for the making of claims under the warranties

6) Tax and other indemnities

7) Mechanisms for deferred payment or enabling P to withhold payment until the warranty and indemnity claims have been dealt with.

8) The exclusion of any claims by P otherwise than for breach of the warranties together with the removal of any right to rescind.

9) Restrictive covenants.

The whole aim of an SPA is to reduce the process of due diligence into two documents, that is to say the SPA itself and the disclosure letter. In practical terms, these documents may well not be read again until the deferred consideration is payable. As well as defining contractual liability, the warranties and the disclosure letter play an important part in the process of due diligence.

4. Most claims relating to SPAs involve a fine analysis of the terms of the warranties and the disclosure letter. This seminar deals with contentious areas which apply generally to such claims including:

1) Mechanisms for making warranty claims or withholding payment
2) The concept of fair disclosure
3) Warranties as to disputes and compliance with laws.
4) P's knowledge of the falsity of the warranty
5) Alternative misrepresentation claims
6) Exclusion of misrepresentation claims
7) Fraud claims
8) Tax and other indemnities
9) The assessment of damages for breach of warranty.

<u>1) Mechanisms for making warranty claims or withholding payment</u>

5. P's common law right to bring an action for breach of warranty will accrue on completion and can be pursued for 6 years thereafter. This is a long time period for V

to maintain funds to meet any potential claim and keep voluminous documents. A well drafted SPA will usually provide that claims under the warranties have to be made in a certain manner involving:

1) A requirement for notice with or without particulars.
2) A shorter time limit than 6 years
3) A global cap or a limit on individual claims. This will be useful if V intend to take out breach of warranty insurance.

Any clause which limits the ability of P to bring an action for breach of warranty is of the nature of an exclusion clause and the same is construed *contra proferantem* against V (see *Nokahar-Cookson v The Hut Group Ltd* [2016] EWCA Cov 128). At least as regards time, there must be strict compliance (see *Stobart Group Ltd v Stobart and Tinkler* [2019] EWCA Civ 1376).

6. Every notification clause turns on its own wording and the usual principles of contractual construction apply (see *Wood v Capital Insurance Services Ltd* [2017] UKSC 24). Most such clauses require P to state *"the nature of the claim"* and sometimes require this to be done *"in reasonable detail"*. The notice letter itself is to be construed on the basis of a reasonable recipient with a knowledge of the underlying facts including the specific terms of the SPA (see *Laminates Acquisition Co v BTR Australia Ltd* [2003] EWHC 2540). As regards the detail requires, the issue has to be determined by reference to the purpose of the notification clause. For most, the purpose will be to enable V:

1) To make inquiries into the factual issues of the claim;
2) To gather or preserve evidence;
3) To assess the merits of the claim; and
4) To take into account the claim its future business dealings.

The notice should not become a technical minefield, divorced from the underlying merits of P's claim (see *Dodika Ltd v United Luck Group Holdings Ltd* [2021] EWCA Civ 638

7. A clause enabling P to withhold payment if it has warranty claims is not one which creates a condition precedent to liability (as its effect is merely to suspend the obligation to pay) and the Court is less likely to require P to provide full details of their claim.

2) The concept of fair disclosure

8. The SPA will specify the effect of the disclosure letter on the scope of the warranties. Usually, the disclosure letter will be in two parts, being:
   1) General disclosure of matters in the accounts of the Company or other documents which P could probably obtain from elsewhere. It will usually include:
      a) The most recent accounts of the Company
      b) All information at Companies House
      c) All information provided on standard conveyancing searches about the properties of the Company
   2) Specific disclosure in relation to specific warranties.

   Invariably, the accuracy of the matters contained in the disclosure letter will also be warranted.

9. The following passage from the Scottish first instance decision in *New Hearts Ltd v Cosmopolitan Investments Ltd* [1997] 2 BCLC 249 is often cited as the broad principle involved.

   > *"Mere reference to a source of information, which is in itself a complex document, within which the diligent enquirer might find relevant information will not satisfy the requirements of a clause providing for fair disclosure with sufficient details to identify the nature and scope of the matter disclosed"*.

10. This principle has to be considered in the light of both the first instance ([2004] EWHC 955 (Ch)) and Court of Appeal ([2005] EWCA Civ 758) decisions in *Infiniteland Ltd v Artisan Contracting Ltd.* Here there were warranties as to the accuracy of the accounts of the Company and general disclosure of accounting records. The unusual feature was that the accountant of P had managed to work out that the accounts of the Company were misleading from the general disclosure. V argued that no claim for breach of warranty could be made because:
    1) The general disclosure was sufficient to reveal that the accounts were misleading; and
    2) P had actual knowledge of the misleading nature of the accounts

11. The clause relating to the effect of the disclosure letter was slightly unusual. It stated:

"... save as set out in the Disclosure Letter, the Warranties in Schedule 3 are true and accurate in all respects and will continue to be so up to and including Completion"

There was no express reference to fair disclosure.

12.. At first instance, Park J adopted the reasoning in *New Hearts* and held that the general disclosure did no more than point P in the right direction. However, he found that P's actual knowledge of the true position precluded the claim because of an express term if the SPA. It is at least implicit in the decision that the normal position is that knowledge of falsity does not bar a claim.

13. The Court of Appeal held that all provisions limiting the scope of warranties by reference to disclosure had to be considered on their specific terms and that there was no general principle of fair disclosure of the sort referred to in *New Hearts*. The general disclosure did identify the misleading nature of the accounts and the warranty was not breached. The Judge's finding as to the effect of the actual knowledge clause was upheld. It is difficult to escape the conclusion that the Court of Appeal was affected by the fact that P had actually become aware of the falsity of the warranties by reason of the general disclosure in deciding whether it was adequate.

<u>3) Warranties as to the disclosure of disputes and compliance with laws</u>

14. Warranties as to the disclosure of disputes and compliance with laws are common and usually cause no particular legal issues. A dispute does not have to be the subject of court proceedings, but there does usually need to be some form of complaint. Compliance with laws includes those which are required for the Company's business to operate and company law generally.

15. Applying such warranties to the conduct of the directors of the Company before the SPA are more of a problem. The recent decision of Joanna Smith J in Inspired Education *Online Ltd v Crombie* [2025] EWHC 1236 has been reported widely due to the colourful language used in the communications between V and his fellow director. P alleged that such communications amounted to gross misconduct or a failure to comply with the law and that the potential claim of the Company against V had not been disclosed. The Judge held that this was not the purpose of the warranties. There

was no dispute because the Company had not sought to use the communications in order to make any claim against V and the communications themselves did not amount to gross misconduct or a failure to comply with the law.

4) P's knowledge of the falsity of the warranties

16. As a matter of logic, the fact that P knows that a warranty is not true should not prevent them from bringing a claim for breach of warranty. V has merely promised that the fact is true and this forms part of the contractual bargain. This point appears to have been accepted by Park J in *Infiniteland.* P might have some difficult in establishing loss if the purchase price was agreed with knowledge of the inaccuracy.

17. The SPA will usually contain a term which sets out that no information provided to P during the due diligence procedure will affect the warranties unless P has actual knowledge of the inaccuracy or notice of the same. All turns on the actual words used as knowledge and constructive notice are different concepts.

5) Alternative misrepresentation claims

18. A warranty is a promise made in a contract that certain facts will be as stated. If that is not the case, then P can bring a claim for breach of contract. A representation is a statement of fact made before the contract is made which induces P into entry into the contract. If the statement is incorrect, P may be able to rescind the contract (subject to bars in equity) or claim damages under section 2(1) of the Misrepresentation Act 1967.

19. There may be reasons why P might wish to rely upon a misrepresentation claim rather than one under the warranties.
    1) The representation may not relate to a fact which is not subsequently warranted
    2) In principle, the measure of loss is different. Section 2(1) of the Misrepresentation Act 1967 allows P to claim their losses with the fiction of fraud.
    3) P may not be able to rely on the warranty because it has not complied with the notice procedure

4) Liability under the warranty may be capped.

5) P may want to rescind.

20. A particular difficulty arises where the misrepresentation claim is founded upon the warranties. It might well be assume that no claim in misrepresentation can be made as the parties have agreed to treat that fact as having been promised rather than as having be stated to be true. However, there are inconsistent first instance decisions on this point.

21. In *Invertec Ltd v De Mol Holding BV* [2009] EWHC 2471 (Ch) Arnold J held that there was no principle which prevented a warranty from being relied upon as a representation as well. There were two reasons for this decision (paragraphs 362 and 363) being as follows:

1) The warranties related to information which had been supplied before the SPA was made as part of the due diligence exercise.

2) The warranties amounted to statements of fact as to the position before the SPA was made.

Both of these reasons would apply to most if not all warranties.

22. In *Sycamore Bidco Ltd v* Breslin [2012] EWHC 3443 (Ch) Mann J held the opposite and provided a detailed analysis of why Arnold J was wrong (at paragraphs 201 to 211). The main reasons were as follows:

1) As a matter of logic, warranties are given in the SPA and cannot induce the making of an SPA.

2) The ability of the parties to treat warranties as representations would enable P to evade the limitations on liability for breach of warranty contained in the SPA which could not have been intended.

23. In *Idemitsu Kosan Co Ltd v Sumitomo Corp* [2016] EWHC 1909 (Comm) the Deputy High Court Judge managed to avoid having to decide between these two inconsistent judgments.

24. Pending referral to the Court of Appeal, *Sycamore Bidco* is the preferable view. Warranties do not arrive out of the blue when the SPA is made. They form the basis of due diligence and will inevitably form the basis upon which P enters into the SPA.

However, the parties have decided to treat V's statements as warranties and they should be treated as such only.

6) Exclusion of misrepresentation claims

25. A well drafted SPA will provide that P accepts that they have entered into the same as a result of the warranties and not as a result of any representation made by V. Such a clause is sensible because it adds to certainty and means that the issues of liability can be limited to the construction of the warranties and the disclosure letter. This type of clause is a "basis clause" rather than an exclusion clause and is not subject to the Unfair Contract Terms Act.

26. Basis clauses allow the parties to agree the factual basis upon which they have entered into the contract. The Court gave effect to such an agreement by way of a contractual estoppel for the first time in *Peekay Intermark Ltd v Australia & New Zealand Banking Group Ltd* [2006] EWCA Civ 386. It has been approved by the Court of Appeal in *JP Morgan Chase v Springwell Navigation* [2010] EWCA Civ 1221. As between contracting parties of equal financial resources, the principle has much to recommend it even if it means that the Court may have to accept that black is white. The problem experienced with this principle is how it can apply as between parties with vastly different financial resources, such as a bank and its customers. Most standard form banking documents relating to interest rate hedging products provide that the transaction has been entered into with no advice. The fact that this might well not be true has not prevented the Court at first instance from accepting the validity of such basis clauses (see *Crestsign Ltd v National Westminster Bank PLC* [2014] EWHC 3043 (Ch) and *Thornbridge Ltd v Barclays Bank PLC* [2015] EWHC 3430 (QB)). Permission to appeal was granted in *Crestsign* but the case was settled before the appeal was heard.

27. The better view must be that there can be no objection to a basis clause which states that no representations have been made by V especially if the SPA has detailed and lengthy warranties by P.

28. No-one has ever sought to argue that a basis clause can be used to defeat a claim based on fraud and the better view is that it cannot (see *Deutsche Bank v Unitech*

[2013] EWCA Civ 1372).

7) Fraud claims

29. Where V have been responsible for making fraudulent misrepresentations with regard to the Company and these have been relied upon by P, then there is an obvious claim in fraudulent misrepresentation or deceit to which the fraud rules of recovery will apply.

30. Problems arise when the fraud is perpetrated by employees or directors of the Company and V have no knowledge of the same. The role of the employee or director in the sales procedure has to be analysed in order to determine whether V are vicariously liable for statements made to P (see *MAN Nutzfahzeuge AG v Freightliner Ltd* [2005] EWHC 2347). In that case, the managing director of the Company had manipulated the accounts for many years in order to hide trading losses of £75m.

8) Tax and other indemnity claims

31. The SPA will usually provide that V will indemnify P in the event that a particular liability of the Company for tax has been understated in its accounts. This sum is claimed in debt and is not subject to any common law restrictions which would apply to a damages claim. Liability is not normally subject to matters set out in the disclosure letter.

32. Tax issues often arise after sale because P's method of operation differs from that of the Company. If P owns more than one company, it may wish to ensure a consistent tax practice over its whole business. P may want to inform HMRC about errors in tax administration. In principle, the tax indemnity should not be affected by voluntary disclosure. The Court may be unable (or extremely unwilling) to determine the tax liability of the Company as between P and V (without the involvement of HMRC). Accordingly, the SPA should provide a mechanism to enable V to be notified of indemnity claims and to have some role in the quantification of the true extent of the tax liability. Compliance with this mechanism will usually be a condition precedent to liability.

9) The assessment of damages

33. A claim for breach of warranty does not require P to prove reliance. The measure of loss is the difference between the value of the Company as warranted and its true value as at completion (see *The Hut Group Ltd v Nobahar-Cookson* [2014] EWHC 3842 (QB)). The Court will ignore matters which were not known at the time unless it is necessary to take them into account in order to properly compensate P (see *The Golden Victory* [2007] 2 AC 353). Often, it is assumed that the value of the Company as warranted equates to the purchase price. This might not be true in all cases. If P has entered into what appears to be a very good bargain, there is no reason in principle why it should be deprived of the profit on the deal. P would need to prove that its assessment of the value of the Company as warranted was justified by reference to some generally accepted methodology..

34. In broad terms, there are two types of warranty giving rise to a claim:
   1) A warranty as to the value of an asset or liability of the Company
   2) A warranty as to a matter which affects the profitability and goodwill of the Company

1) Company assets or liabilities

36. If an asset of the Company has been overvalued or a liability undervalued, P's loss will usually equate to such over or under valuation. However, this presupposes that P has attributed a value to the net assets of the Company. It might not have done. It might have valued the Company purely on the basis of a price/earnings ratio and might be unconcerned as to the net assets. To deal with this possibility, a well drafted SPA will require V to pay damages equal to the loss suffered by the Company.

2) Profitability of the Company

37. Where there has been a breach of warranty relating to a matter affecting the profitability of the Company (such as gross or net profits), the assessment of loss is much more difficult as there are many ways in which profitability is or can be used to negotiate the purchase price. The Court is looking primarily at a hypothetical willing seller and a hypothetical willing buyer (see *Arani v Cordic Group Ltd* [2023] EWHC

93 (Comm)) However, when P and V have valued the Company on the same basis (such as by reference to EBITDA) than this will help significantly the assessment procedure as it will provide powerful evidence as to the attitude of the hypothetical V and P.

38. There are a number of ways of valuing the Company in its true state being as follows:

1) Using the method adopted by both P and V in agreeing on the purchase price.
2) Using the method adopted by P in agreeing the purchase price.
3) Using a generally accepted method of calculation (as might be used in an unfair prejudice petition).

39. Method (1) has much to recommend it and may well be adopted where it is clear that V and P have negotiated openly and fairly by reference to a sensible agreed methodology. However, this might preclude a claim if P and V have adopted a method which uses a criteria unaffected by the warranty. If they have used a multiplier on gross profit, warranties affecting expenditure would not affect the true value of the Company.

40. Method (2) is the simplest to plead because it depends on the instructions given by P. It is often adopted by the Court especially where P's approach to valuation is in accordance with industry norms and correctly arrives at the purchase price. It was adopted in *Ageas (UK) Ltd v Kwik-Fit (GB) Ltd* [2014] EWHC 2178 (QB).

41. Method (3) is often adopted effectively by default and ought to be pleaded as an alternative in most cases.

42. As with many other areas of the law, the exercise is hampered by the fact that the leading case, the decision of the Court of Appeal in *Senate Electrical v STC* [199] 2 Lloyds Rep 423 was decided on the basis of inadequate pleadings amended very close to trial. In *Senate Electrical* the Company had net assets of £70m and was purchased for £90m. The annual profits of £9.7m were held to have been overstated by £1.7m. P's only pleaded claim was that it had assessed the value of the Company purely on the basis of a price/earnings ratio of 14 and that the loss which it had suffered was 14 times the overstatement. The claim was for more than £20m. There was no alternative claim based upon how a reasonable purchaser would have assessed the value of the

Company or that P would have attempted to negotiate a lower purchase price if it had known the truth. Not surprisingly, the trial Judge found as a fact that P had not actually valued the Company in this way. The valuation exercise was more complicated and related to P's desire to enter the market at that time. As the Judge was not able to accept P's only pleaded case, but considered that P had suffered a loss, he considered that it was appropriate to assess loss based upon the reduction which P would have been able to obtain and held that this was £5m.

43. In the Court of Appeal all parties accepted that the loss suffered was the difference between the value of the Company as warranted (assumed to be the purchase price) and the true value of the Company. This might not be correct if P negotiated a bargain. V contended that P had suffered no loss because it could not prove that it had suffered the loss contended for, there was no alternative claim based upon what a reasonable purchaser would have done and the evidence as to what might have happened if P had known the truth was inconclusive at best. The appeal was allowed and P recovered nothing.

44. In *Nukem*, Gloster J emphasised that any claim based upon the ability of P to negotiate a lower price was illogical because warranties are only given in the contract itself and the contract cannot be renegotiated at that time.

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